

I. Executive Summary

This chapter provides the overall results and recommendations developed during this audit of South Jersey Gas Company (SJG) competitive services and affiliate relationships, conducted on behalf of the New Jersey Board of Public Utilities (BPU) in July, August, and September 2000.

A. Audit Objectives

The overall objective of this Competitive Services Offerings and Affiliate Standards Compliance Audit is to ensure that South Jersey Gas Company and/or its related competitive business segments do not have an unfair competitive advantage over other, non-affiliated purveyors of competitive services. The focus of the audit was to evaluate and review SJG's compliance with the BPU's *Final Interim Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements (Affiliate Standards)* which were adopted by the Board in Order EX99030182 on March 15, 2000. SJG's Compliance Plan in response to this order was filed on June 15, 2000.

B. Report Outline

This report includes the following chapters:

- ◆ *Introduction*, including findings and recommendations relative to SJG's compliance plan
- ◆ *Management and Organization*, including a summary discussion of the background and structure of SJG. This chapter also includes findings and recommendations relative to SJG's compliance with the *Affiliate Standards* pertaining to:
 - Shared officers and directors (Section 5.5 of the *Affiliate Standards*)
 - Advertising (Section 5.6)
 - Separation (Section 5)
- ◆ *Asset Transfers*, including an analysis of asset transfers over the past three years, as well as findings and recommendations relative to SJG's compliance with the *Affiliate Standards* pertaining to asset transfers between the regulated and non-regulated entities/competitive services (Section 5.9)
- ◆ *Employee Transfers*, including an analysis of employee transfers over the past three years, as well as findings and recommendations relative to SJG's compliance with the *Affiliate Standards* pertaining to employee transfers between the regulated and non-regulated entities/competitive services (Section 5.7)



- ◆ *Service Transactions*, including an analysis of personnel and other transactions over the past three years, including transaction sampling analysis. This chapter also includes findings and recommendations relative to SJG's compliance with the *Affiliate Standards* pertaining to:
 - Cost allocation (Section 6)
 - Accounting standards (Section 6.4)
 - Books and records for non-regulated entities/competitive services (Section 6.4)
- ◆ *Competitive Services Offerings and Affiliate Standards Database*, including summary reports showing each affiliate and competitive service's compliance with each *Affiliate Standard*, produced using the database tool Schumaker & Company developed to assist in this audit

C. Recommendations

The following is a detailed listing of the recommendations contained in this report.

Recommendation Number		Recommendation Statement	Page
1	Recommendation II-1	Resubmit the SJG Compliance Plan after incorporating the findings and recommendations of this report. (Refer to Finding II-1).	8
2	Recommendation III-1	Reorganize SJI in such a manner that no individuals serve as directors or officers for both the regulated and non-regulated entities (Refer to Finding III-1).	22
3	Recommendation III-2	Establish specific mechanisms and procedures within SJG to ensure that it complies with the Affiliate Standards for shared officers and directors (Refer to Finding III-1).	22
4	Recommendation III-3	Document the provision of support services between SJI and SJG through the implementation of contracts and service agreements (Refer to Finding III-2).	22
5	Recommendation III-4	Establish a service company within SJI as part of its reorganization (Refer to Finding III-2).	22
6	Recommendation IV-1	Establish procedures to ensure and document regulatory compliance for asset transfers, leases, or rentals. (Refer to Finding IV-1, Finding IV-2, and Finding IV-3)	27
7	Recommendation V-1	Establish policies within SJG and its affiliates to ensure that employee transfers are consistent with the Affiliate Standards. (Refer to Finding V-1).	31
8	Recommendation V-2	Develop a method of apportioning pension costs within SJI between affiliates for employees who transfer. (Refer to Finding V-2).	31
9	Recommendation VI-1	Update operating procedures for accumulation, assignment, and allocation of costs involving affiliates and competitive service segments of South Jersey Gas Company. (Refer to Finding VI-1).	61
10	Recommendation VI-2	Initiate a project to unify the cost allocation development and modification process under a single point of focus. (Refer to Finding VI-2 and Finding VI-3).	61
11	Recommendation VI-3	Develop a formalized SJI/SJG cost allocation policy. (Refer to Finding VI-4).	62

12	Recommendation VI-4	Develop and implement a new procedure for allocating corporate and other overhead charges between appliance service and utility distribution work to replace the current 60%/40% scheme. (Refer to Finding VI-5).	62
13	Recommendation VI-5	Ensure that a cost allocations audit of affiliates and competitive service segments of SJG is performed in a timely manner. (Refer to Finding VI-6).	62
14	Recommendation VI-6	Correct deficiencies noted by Schumaker & Company in sampling of transactions and ensure that sufficient information is included in cost allocation manual to prevent these deficiencies from happening in future. (Refer to Finding VI-7).	62



II. Introduction

This report has been submitted in response to a request for proposal (RFP) from the New Jersey Board of Public Utilities (the Board or the Commission) for a consulting firm to conduct compliance audits of the competitive services of South Jersey Gas Company (SJG). The purpose of this audit was to ensure that South Jersey Gas and/or its related competitive business segments do not have an unfair competitive advantage over other, non-affiliated purveyors of competitive services, and to evaluate and review the allocation of costs between South Jersey Gas competitive and non-competitive services.

This report assessed whether there is strict separation and allocation of each utility's revenues, costs, assets, risks, and functions between the utility's gas distribution operations and its related competitive business segments. The audit also determined:

- (1) Whether cross-subsidization between utility and non-utility segments within a public utility or holding company exists;
- (2) Whether the separation of utility and non-utility organizations is reasonable based on the Board's affiliate relation and fair competition standards;
- (3) The effect on ratepayers of the use of utility assets in the provision of non-safety-related competitive services;
- (4) The effect on utility workers;
- (5) The effect of utility practices on the market for such services; and
- (6) Compliance with the *Affiliate Standards*.

The audit will provide the Board with the information necessary to determine whether the competitive services identified are in any way cross-subsidized by South Jersey Gas's regulated activities and to determine the reasonableness of the lump-sum charges (i.e. service contract rates) and the time-and-materials charges encountered in a competitive environment.

The results of the audit will be used in conjunction with information gathered by staff in determining whether South Jersey Gas is in compliance with the intent of NJSA 48:3-55, 48:3-56, and 48:3-58 to restructure New Jersey's gas industry to create open competition without undue consequences to the safety, adequacy, and propriety of traditional, basic utility service.

A. Synopsis of Audit

The State of New Jersey Board of Public Utilities (BPU) requires all gas public utilities to adhere to the requirements set forth by the BPU under the *Final Interim Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements (Affiliate Standards)* that was adopted by the Board in Order

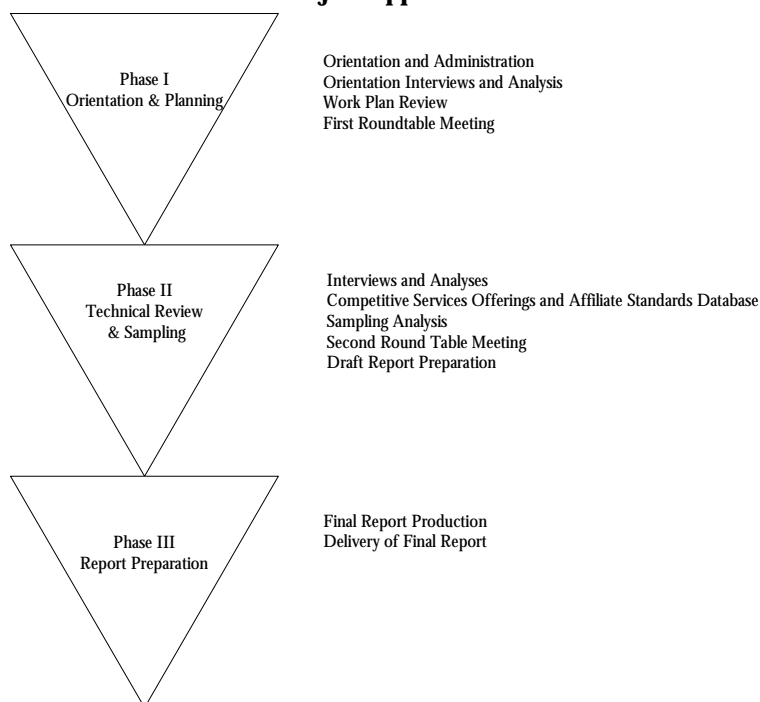
EX99030182 on March 15, 2000 in relation to the Electric Discount and Energy Competition Act of 1999, P.L. 1999, c.23.¹ Definitions in the *Affiliate Standards* that are most relevant to this report are:

- ◆ “Affiliate” is defined as a related competitive business segment of a gas public utility or a related competitive business segment of a public utility holding company.
- ◆ “Related competitive business segment of a public utility holding company” is defined as any business venture of a public utility holding company (not a utility), including, but not limited to, functionally separate business units, joint ventures, and partnerships and subsidiaries, that offers to provide competitive services.
- ◆ “Related competitive business segment of a gas public utility” is defined as any business venture of a gas public utility including, but not limited to, functionally separate business units, joint ventures, and partnerships, that offers to provide or provides competitive services.

This audit was conducted in three phases that are shown schematically in *Exhibit II-1*. These phases provided the Schumaker & Company project team with a structured approach that is comprehensive and logical, as well as interactive and participative with the Board and the utility.

To assist our staff in these investigations, we developed a *Competitive Services Offerings and Affiliate Standards Database* to facilitate our investigations on this project. This tool is further described in *Chapter VII*.

**Exhibit II-1
Project Approach**



B. Audit Team

Schumaker & Company's audit team for the Competitive Services Offerings and Affiliate Standards Compliance Audit of South Jersey Gas Company consisted of the following individuals:

- ◆ Dennis J. Schumaker, Engagement Manager
- ◆ Patricia H. Schumaker, Lead Consultant
- ◆ Martin J. Murphy, Lead Consultant
- ◆ Karen K. Sikkenga, Consultant
- ◆ Hugo E. Romero, Consultant

¹ / RFP Attachment 3